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SUBJECT: FRENCH ECONOMIC GROWTH 1.5% IN 2005

1. SUMMARY. The National Statistical Agency forecast 1.5% GDP growth in 2005, the bottom end of the government's official 1.5-2.0% prediction. The forecast takes into account oil price increases and government programs for job creation. Corporate growth is weak, but could edge up in the second half. Export growth is likely to stay moderate, remaining below import growth. The government scenario of 2.0-2.5% GDP growth in 2006, on which the 2006 budget is based, is unlikely, absent an immediate acceleration in economic growth. END SUMMARY.

No Acceleration in GDP Growth in 2005

2. The National Institute for Statistical and Economic Studies (INSEE) did not revise its June Forecast, still expecting GDP to increase by 1.5% in 2005, the bottom end of the government 1.5-2.0% target. INSEE forecast GDP to increase 1.6% (annualized) in Q-3 and to ease back to 1.2% in Q-4 after increasing 1.6% in Q-1 (more than expected in June) and edging 0.4% in Q-2. INSEE notably revised downward its initial estimate of Q-4 GDP growth from 2.4%, taking into account negative impacts of oil prices increases on the French economy. INSEE's chief economist Michel Devilliers stressed, "economic growth is yielding, but is not breaking." Nonetheless, French economic growth in 2005 should be significantly lower than growth in the U.S. (3.4%), but should surpass growth in the euro zone (1.3%).

3. Taking into account oil price increases INSEE revised upward its 2005 inflation forecast to 2.1% from 1.5%. That said, INSEE expected job creation to more than offset the negative impact of oil prices on households' purchasing power. Boosted by a 1.9% increase in purchasing power in 2005, household consumption, which rebounded in Q-3 based on indicators, after decreasing 0.8% in Q-2, is expected to increase at a more normal pace by the end of the year.

Unemployment Rate Decreases Slightly at the End of 2005

4. INSEE forecast net job creation to increase 91,000 in 2005, permitting the unemployment rate to decrease to 9.7% by the end of 2005. This is slightly better than the 9.8% predicted in June, and down from 10.0%, the level recorded at the beginning of 2005. The private sector could create 50,000 jobs in the construction and the services sector compared with 5,000 in 2004, notably due to the New Recruit Contract ("Contrat Nouvelles Embauches" CNE). Karine Berger, head of the INSEE's Short-term Economic Analysis Division, acknowledged that forecasting job creation related to the CNE is difficult. She estimated that 10,000 to 20,000 CNEs might be created by the end of 2005. (The 100,000 CNEs announced in the press are only promises, not signed contracts).

5. Job creation would also be significant in the public sector thanks to government-subsidized contracts related to the government's Social Cohesion Plan. For the first time in three years, the public sector would create 61,000 jobs.

Trade a Major Drag on Growth but Investment May Rise

6. INSEE forecast imports - boosted largely by consumption - to increase 5.2% in 2005, more than exports (2.2%). In 2005, foreign trade will have a negative 0.9% impact on GDP growth. At the end of August, the foreign trade deficit (fob/fob, s.a.) stood at 15.1 billion euros, exceeding the entire trade deficit of 2004. Karine Berger stressed that the strong euro, apparently anchored above USD 1.20, hampered the competitiveness of French exports more severely than expected. INSEE used a 1.23 USD-euro exchange rate in its forecast, the euro average since August 1.

7. Berger also noted that the manufacturing sector has been having difficulties, and continued to be affected by sluggish domestic demand in the euro zone, France's major

trading partner. Nonetheless, INSEE forecast corporate investment to increase 1.4% (annualized) in Q-3, and 1.6% in Q-4, after decreasing 4.0% in Q-2.

Main Risk: Oil Prices

18. INSEE underlined that strong elasticity of oil prices and changes in demand for oil could still affect its forecast. The approach of winter is creating new uncertainty about oil prices. On the other hand, recent price increases could drive a decrease in the world demand for oil, which could ultimately result in a long-term decrease in oil prices.

19. INSEE economists opined that only a decrease in the euro against the U.S. dollar or a recovery in domestic demand of France's trading partners (Germany, Italy and the U.K., which recorded its lowest GDP growth in the last twelve years) could give breath to French industry.

Difficult to Reach 2.0-2.5% GDP growth in 2006

10. Devilliers remarked that the Consensus growth forecast of 1.8% GDP growth in 2006 requires 2.0% (annualized growth per quarter). Reaching 2.25%, the middle of the 2.0-2.5% Government forecast would be even more difficult, requiring 2.8% (annualized) growth per quarter. He stated "everything is open in 2006", but remarked that "a quick acceleration is not taking place now."

COMMENT

11. Despite low interest rates, corporate investment growth remained weak due to uncertainties caused by rising oil prices. "Liberal" economists, including member of the "Conseil d'Analyse Economique" Michel Didier said that the situation was not so bad to necessitate vigorous budget measures to boost domestic demand, but suggested the government should concentrate its economic policy on competitiveness and investment. INSEE's forecast confirms that the government scenario of 2.0-2.5% GDP growth in 2006, on which the 2006 budget is based, is unlikely, absent an immediate acceleration in growth. Acceleration in growth requires further structural reforms. However, even if any were implemented (no major reforms are contemplated), they would not have any immediate effect.
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